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# DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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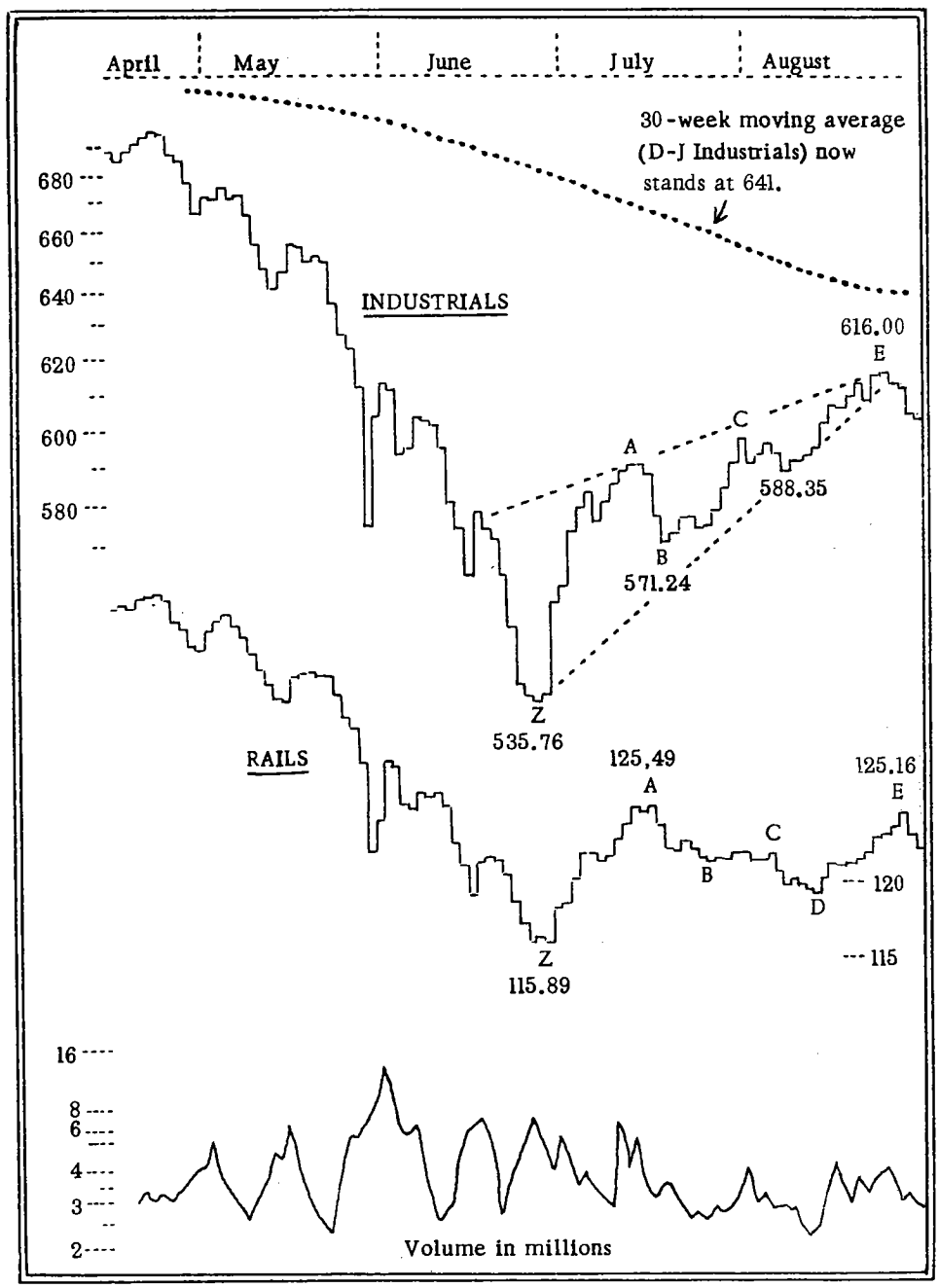
THE MARKET On August 23 the Industrial Average closed at a recovery high of 616.00 (E on chart). By so doing, Industrials retraced a normal 43% of the entire 190 point second bear leg (the second bear leg began in March and ended in June).

On August 27 the Rail Average rose to 125.16 (E). This move took carriers to within 33¢ of their preceding July 12 peak. Following the belated attempt by Rails to better their July 12 high, the two Averages promptly turned down. August 28 saw Industrials drop 7.32 points, Rails 1.34.

On page 2 of the last Letter I stated: "If Rails spurt to or above the July 12 peak--and immediately turn down--I would view this action as distinctly unfavorable if not ominous."

The big question now--has the secondary (upward) correction terminated, or is the market merely declining preparatory to another consolidation and upward push? While no one can do more than hazard a guess, my own feeling is that the upward move could well be over.

One guidepost will be helpful in determining the direction of the secondary trend. The upward correction began for Industrials on June 26 at 535.76. Industrials touched a high of 616.00 on August 23. If, on any decline, Industrials are able to hold above the halfway mark of the June-August rise, the implications will be hopeful. However, if a decline succeeds in breaking the halfway mark of the June-August advance, the implication will be that the third primary bear leg is underway. The halfway level of the June-August advance stands at 575.




WEDGES One of the chart formations which should be discussed at this time is the "wedge". A wedge is a pattern formed by two converging trendlines, but the wedge differs from the triangle in that in wedge formations both trendlines slant up (in rising wedges) or down (in falling wedges).

Although a rising wedge would seem at first glance to be a bullish formation--it is

not. It typifies a situation in which investment interest is slowly petering out. In a rising wedge prices advance, but each new wave is more feeble than the last. Finally, demand completely disappears, and the rising wedge reverses into a downtrend. According to Edwards and Magee ("Technical Analysis of Stock Trends"): " Once prices break out of the (rising) wedge on the downside, they usually waste little time before declining in earnest. The ensuing drop ordinarily retraces all of the ground gained within the wedge itself, and sometimes more. Trading volume in a wedge tends to follow the regular triangle pattern, diminishing gradually as prices move up towards the apex of the wedge."

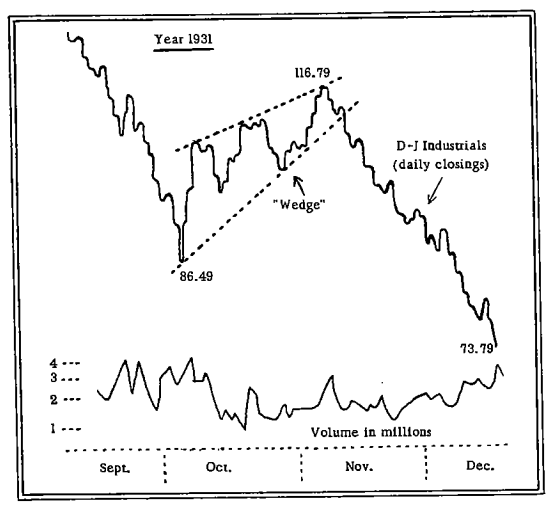
Later Edwards & Magee state: "As a final note, we might add that the rising wedge is a quite characteristic pattern in bear market rallies. It is so typical, in fact, that frequent appearance of wedges at a time when, after an extensive decline, there is some question as to whether a new bull trend is in the making, may be taken as evidence that the primary trend is still down."

On rare occasions (during bear markets), wedges appear in one or the other Average. During the great bear year 1931 a wedge appeared ( in Industrials ) prior to the year-end collapse. During February and March of 1932 another wedge appeared, immediately preceding the final drastic bear market decline. I have included a chart showing the 1931 Industrial wedge. Note the erratic volume which followed the huge "crash"-volume of September-October, 1931.

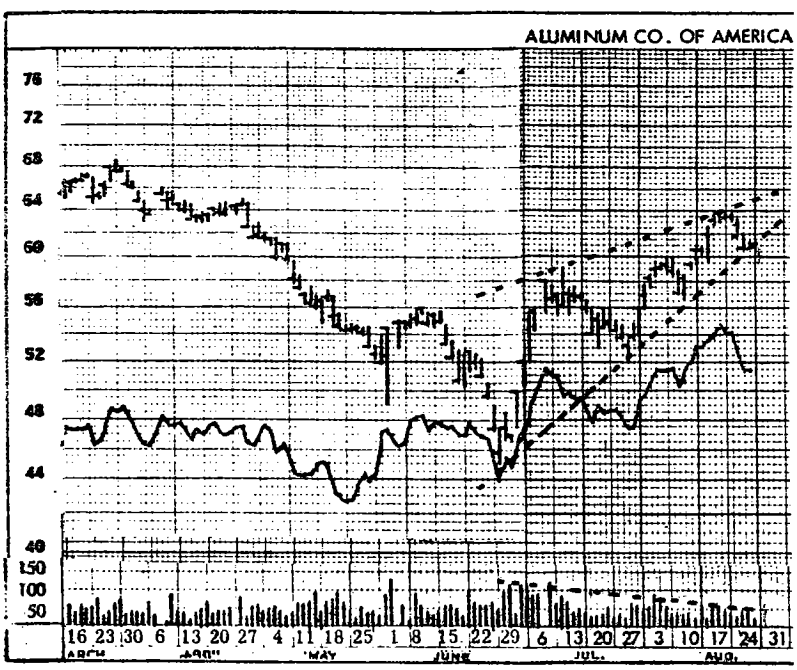
Referring to the chart on page 1, I have drawn trendlines on the Industrial Average outlining a rare wedge pattern. On August 27 (with Rails failing by a fraction to confirm) the Industrials diverged (declined). The minor decline of August 27 took Industrials below the lower trendline of the wedge. On August 28 all doubts were removed as Industrials dropped decisively below the wedge formation. This writer takes the breaking of the wedge pattern as bearish. I believe that traders and investors ( if they have not already done so) should move to protect themselves.

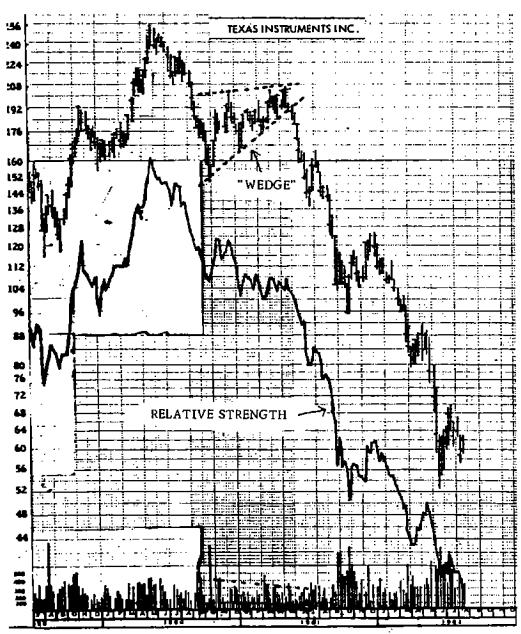
I have included a chart of Texas Instruments (weekly) showing the giant head-and-shoulders top of 1960. The right shoulder of that formation took the form of a rising wedge. When the wedge was broken, Texas Instruments went into one of the most dramatic collapses of the bear market.

It is interesting to observe that a number of wedges are now appearing in the charts of individual stocks (this is a much more common phenomenon than a wedge in the Averages). Currently, Alcoa (see chart) is in a wedge formation, and on August 24 this wedge was broken on the downside. Note the diminishing volume as the Alcoa wedge developed. Other stocks currently in wedge formations are Burroughs (see Letter 190), Northwest Airlines, Reynolds Metals, General Electric, Metro Goldwyn and North American Aviation.




BEAR MARKETS Americans invented the word "gimmick", and over the past few decades the idea of the gimmick has loomed larger and larger in the philosophy of economics and the stock market. Thus inflation, demonitization of the debt, margins, consumer credit plans, parities,



etc., have served to inculcate in the American mind the theory that when things go wrong, you simply find another "gimmick button" to press.

There is only one factor which can exert a continuing influence on the trend of common stock prices, and this is a sustained expansion or contraction in corporate earnings. When a bull market hits its final peak, it may be said that the market has fully discounted all the favorable phenomena which can possibly affect corporate profits. But an extended bull market, by its very nature, builds "fat", inefficiencies, debts and high hopes. A corporation will not expand (and over-expand) unless it is optimistic about the future trend of business. A corporation will not assume new debt, it will not add new divisions, it will not raise executive salaries -- unless it feels reasonably confident about the future.

At or near the highs of a bull market, informed investors (sensing a major turn) will distribute their equities. Such distribution usually takes place in an atmosphere of universal "well-being", and of course the rosier the view, the better the prices and the more stock the market can absorb.

During a bear market the Averages turn down in an attempt to measure the worst that can be seen over the period ahead. A bear market will terminate when the market is convinced that the period of contracting earnings is at or near an end. Just as bull markets breed bullishness (because the price of everything is rising), bear markets beget bearishness (because the price of everything is heading down).

In the current situation, we can now pick up our newspapers and read mixed reports concerning the economy. Volume of business has not dropped significantly yet, and the consumer (who is always the last to realize that anything is wrong) is still merrily buying away. But against this we also read that commodity prices are falling, corporate profits are still being squeezed, retail prices are under pressure (witness the vicious competition in the retail field and the rise of the discount stores), and perhaps most dramatic of all, the giant real estate market is finally tottering (see Barron's, August 6, page 1).

Yet, for all the pain it may cause, a bear market also serves a function and a very valuable one. Hamilton (in a prophetic piece written in the late '20's) described this function in connection with what he considered to be the growing inefficiencies and inflationary pressures of that period: "The stock market," he wrote, "has a short and simple method of dealing with 'water' in stocks. It exists for the purpose of squeezing that water out."

Gimmicks cannot stop a bear market. Brave words, promises, hopes and threats can only produce a ripple in a tide which has turned down. Nevertheless, our Administration has recently seen fit to dangle the "plum" of a tax cut in front of the American people. If a tax cut can solve the problems of massive debt, high-priced labor, foreign competition, over-production and "feather-bedding", then a tax cut will turn the tide. But if a tax cut simply adds another seven billion to the next deficit -- then it will do more harm than good. All these things the market considers -- with more accuracy than this writer or any other writer can hope to muster.

SUNDRY COMMENTS One investment service (for which I have the highest regard) issues a periodic denunciation of the Rail Average as a confirmatory tool. In their latest Letter they say: "The undue importance attached to the Rails is, we believe, simply a hangover from the past. At one time the Rails were 'the market'. In 1902, for example, 75% of all Stock Exchange transactions were in railroad stocks, but their prominence has been gradually diminishing over the years."

All this may be true, but the simple fact is that freight cars last year carried 43.3% of the ton-miles of goods transported while trucks hauled only 22.6% of the traffic. Moreover, Rails tend to carry "the cargo that counts." Therefore, if there is to be an appreciable increase in the volume of business over the next three to six months, it seems logical to me that rails will reflect that increase with expanding carloadings, rising profits and higher prices for rail stocks.

In each of the 19 weeks preceding June 2, 1962, rail carloadings were running ahead of the comparable weeks in 1961. Since June, however, rail carloadings have consistently lagged behind the 1961 totals.

As of this writing the Rail Average has failed to better its July 12 peak. It will be interesting to see whether Industrials can make important upside progress from here without confirmation and "in gear" action from that "old fashioned index", the Rail Average.

LATE NOTES The recent market action has revived memories of 1961. During the March to December, 1961, period I repeatedly wrote that the two Averages seemed unable to stay in gear. At no time from March, 1961, to December, 1961, were the two Averages able either to rise to new highs together or break to new lows together. In retrospect (see last Letter) we must conclude that this long series of non-confirmations and divergences represented distribution.

On the rise from the June 26, 1962 lows, the impressive (in-gear) upside action terminated on July 12. Following the joint recovery highs of July 12, Rails declined while Industrials continued to push steadily higher. Industrials recorded their recovery peak (616.00) on August 27. Then as Rails finally rallied for an assault on their July 12 peak, Industrials (which had been the leaders all the way up) unexpectedly turned down! On August 28 the market broke badly with the two Averages in gear on the downside. August 29 saw this weakness extended as Industrials sank to 603.23, and Rails dropped another point to 122.82. As this is written (August 30, 11 A.M., N.Y. time) the Industrials are fractionally higher, Rails are unchanged, and volume is dull.

Conclusion: The primary trend is bearish. The secondary trend is probably in the process of turning down. I would now consider any minor downward zig-zag in Industri als a distinct danger signal.

STOCKS AND MOVING AVERAGES I have received a number of questions regarding the 30-week moving average of the D-J Industrials (which appears in each Letter on page 1). This long-term moving average has been likened to "an investment line." It shows what investors have been willing to pay (on average) for the D-J Industrial stocks over the past seven months. During extended bear markets the Industrial Average tends to hold below its own long-term moving average -- with rallies or corrections often rising to (or even temporarily above) the moving average line. During bull markets the reverse relationship exists -- with Industrials tending to hold above the moving average line.

Attention was directed to the moving average in the last Letter. It was stated that Industrials were within 26 points of the 30-week moving average -- and that major resistance should be expected on any near approach to that area (i.e., 647).

Referring to individual stocks, it is of interest that of 346 representative issues on the N.Y. Stock Exchange, only 30 (less than 10% are currently above their 30-week moving averages. This is hardly an impressive score.

As long as the bear market exists, our number one job is the classification of the primary trend. As an aid in this direction, I will post in each Letter a tabulation of the number of stocks (346 issues will be used) which are above and below their long-term (30-week) moving averages. During a bull market, I would expect 50% or more of all stocks to be above their moving averages at any given time (except during the most severe reactions). During a bear market, I would expect the converse to hold true.

I mentioned in recent Letters that in going over the charts of many hundreds of individual stocks, one thing stood out clearly. Although many stocks had traced reversal formations -- there was no real volume on the rise. That phenomenon has continued, and I cannot see how any bullish conclusions can be drawn from the situation.

I include charts of two typical issues, Eastman Kodak and General Electric. Kodak has traced a reverse head-and-shoulders pattern. But note the steadily diminishing volume as the stock works higher.

The same can be said of G.E. Following a head-and-shoulder reversal, the stock pushed above 69 (while volume decreased). Over the past week G.E. has faltered without evincing any real upside strength.

Charts of Alcoa, Kodak and G.E. courtesy of Traders Research, Box 2644, St. Louis 16, Mo.